WHO SAYS A CLAIM IS A CLAIM IS A CLAIM? SUBORDINATION, RECHARACTERIZATION AND OTHER CLAIMS ISSUES

32ND ANNUAL NATIONAL CLE CONFERENCE
JANUARY 7-11, 2015
VAIL, COLORADO

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EQUITABLE SUBORDINATION

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EQUITABLE SUBORDINATION BASICS

Key Principles:

- Equitable subordination is a remedial measure, not penal, employed to correct some wrong.
- By its nature, the remedy alters substantive rights, "subordinating" an otherwise valid claim to other claims.
- Focus is on the conduct of the parties. Must have a "bad act" and actual harm to creditors.

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EQUITABLE SUBORDINATION BASICS

Pepper v. Litton, 308 U.S. 295 (1939) (citations and footnotes omitted; emphasis added)

Hence, this court has held that ***a bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence***. And the mere fact that a claim has been reduced to judgment does not prevent such an inquiry . . . . [the court] may ascertain the validity of liens, marshal them, and control their enforcement and liquidation. And the bankruptcy trustee may collaterally attack a judgment offered as a claim against the estate for the purpose of showing that it was obtained by collusion of the parties or is founded upon no real debt. *Id.* At 305-306.

That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it pari passu treatment with the claims of other creditors. ***Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence***. *Id.* At 306.

As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy, ***in the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate***. *Id.* at 308**.**

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EQUITABLE SUBORDINATION BASICS

Benjamin v. Diamond (In re Mobile Steel Company), 563 F.3d 692 (5th Cir. 1977)

Decided under the Bankruptcy Act, but universally cited and referred to in Code cases.

Sets out "three cubed" principles:

A. *Three things that must be present for equitable subordination to be appropriate*

B. *Three principles of equitable subordination*

C. *Three classes of misconduct that may lead to equitable subordination.*

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EQUITABLE SUBORDINATION BASICS

A. Three things that must be present for equitable subordination to be appropriate:

1. The claimant must have engaged in some type of inequitable conduct.

2. The misconduct must have resulted in an injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.

3. Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.

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B. In determining whether the prior three conditions have been satisfied, three principles must be reviewed:

1. Inequitable conduct against the debtor or its creditors may be sufficient to warrant subordination of a claim regardless of whether it was related to the acquisition or assertion of the claim.

2. A claim should only be subordinated to the extent necessary to offset the harm which the debtor and its creditors have suffered on account of the inequitable conduct.

3. Allocation of the burden of proof: an objection based on equitable grounds must contain some substantial factual basis. The objecting party must come forward with enough evidence to overcome the prima facie validity of the claim, which places the burden back on the claimant to prove the validity and honesty of the claim.

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C. For the purposes of an equitable subordination analysis, alleged misconduct can be divided into three classes.

1. Initial undercapitalization.

"[F]or the purposes of determining whether claims against the bankrupt estate held by organizers or shareholders should be subordinated on the ground of undercapitalization, the amount of capitalization that is adequate is what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable capitalization in the light of any special circumstances which existed at the time of incorporation…."

2. Mismanagement, breach of fiduciary duties, and abuse of fiduciary position.

3. Other allegedly inequitable conduct towards the debtor or creditors.

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OTHER EQUITABLE SUBORDINATION CASES

United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (Matter of United States Abatement Corp., 39 F.3d 556 (5th Cir.1994) (Restating and reinforcing *Mobile Steel* factors and holding that exercising contractual right of recoupment is not inequitable or sufficient "control" over the debtor to warrant equitable subordination).

In re Lifschultz Fast Freight, 132 F.3d 339 (7th Cir. 1997) (Turning to the "most influential discussion of equitable subordination, the magesterial *Mobile Steel*" for discussion of three conditions that must exist before a claim may be equitably subordinated; also refusing to adopt a no-fault rule for equitable subordination, referring to a prior 7th circuit case on tax penalties *(see also Sender* case, later in materials, on this point, and *In re Sentinel Mgmt. Group, Inc*., 728 F.3d 660, 669-72 (7th Cir. 2013) (discussing concept of equitable subordination and requirements for same)).

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OTHER EQUITABLE SUBORDINATION CASES

Wooley v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355 (5th Cir. 2008) (Reinforcing *Mobile Steel* factors, the fact that there must be actual harm, and stating that the determination to subordinate must be supported by specific findings and conclusions with respect to each requirement).

******BONUS RULING****** *"A deepening insolvency theory of damages has been criticized and rejected by many courts. We agree with the Third Circuit Court of Appeals, which recently concluded that deepening insolvency is not a valid theory of damages." Id.* at 363-64 (footnotes omitted).

Quoting *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006), the Fifth Circuit stated: "even when a firm is insolvent, the directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at t that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success."

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OTHER EQUITABLE SUBORDINATION CASES

Elway Co. LLP v. Miller (In re Elrod Holdings Corp.), 392 B.R. 110 (Bankr. D. Del. 2009) (Equitable subordination is not a cause of action specific to a debtor in possession or trustee; a secured creditor may seek equitable subordination of another creditor's claim).

"[A] secured creditor is capable of having suffered a particularized injury and . . . a court may fashion a remedy in response to that injury that benefits only the affected secured creditor and not all general creditors ultimately seeking to recover from a debtor's estate. An injured secured creditor should be permitted to pursue its separate interest apart from the trustee. Accordingly, the court holds that a secured creditor has standing to seek the equitable subordination of another secured creditor's claim to the extent that it seeks relief for a particularized injury, which differs from the injury incurred by all creditors." *Id.* at 115.

See also In re Vitreous Steel Prods., 911 F.2d 1223 (7th Cir. 1990); *Cadleway Props. Inc. v. Andrews (In re Andrews)*, 2009 WL 1076831 (Bankr. S.D. Tex. April 2, 2009) (citing cases).

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RECHARACTERIZATION

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RECHARACTERIZATION BASICS

Key Principles:

- Focus is on substance of transaction rather than form.
- No wrong, inequitable conduct or harm is necessary to employ the remedy.
- No alteration of substantive rights; instead, merely recognizes the true nature of the transaction and the relative rights of the parties stemming therefrom.
- Arguably, it's not "re-" characterization, but straight-up "characterization."

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RECHARACTERIZATION CASES

Seminal case:

Roth Steel Tube Co. v. Commissioner, 800 F.2d 625 (6th Cir. 1986)

Tax case examining whether tax payer could take a bad debt deduction for un-repaid advances to a subsidiary, or whether the advances were capital contributions thus limiting the deduction only to the extent of capital gains. Looking to prior decision of 6th Circuit, *Smith v. Commissioner*, 370 F.2d 178, 180 (6th Cir. 1966), the court identified eleven (11) factors for use in determining whether an advance is a loan or a capital contribution:

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RECHARACTERIZATION CASES

Eleven factor test

(No one factor controls. Must look to the facts and circumstances of each case)

1. Names given to the instruments (if any) evidencing the indebtedness
2. Presence or absence of a fixed maturity date and schedule of payments
3. Presence or absence of a fixed interest rate and interest payments
4. Source of repayments
5. Adequacy or inadequacy of capitalization
6. Identity of interest between the creditor and stockholder
7. Security, if any, given for the advance
8. Corporation's ability to obtain financing from outside institutions
9. Extent to which the advances were subordinated to the claims of outside creditors
10. Extent to which the advances were used to acquire capital assets
11. Presence or absence of a sinking fund for repayments

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RECHARACTERIZATION CASES

Employing its 11 factor test, *Roth Steel* court found the advances to be capital contributions, upholding ruling of lower court.

Other cases

Bayer Corp. v. Masco Tech, Inc. (In re Autostyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001):

- Equitable subordination and recharacterization case
- Adopts Fifth Circuit's *Mobile Steel* analysis for equitable subordination (fact of insider relationship alone is not enough for equitable subordination because insiders have the greatest interest in seeing success)
- Adopts and follows the *Roth Steel* factors
- Good discussion of loan participations

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RECHARACTERIZATION CASES

Sender v. The Bronze Group, Ltd. (In re Hedged-investments Assocs., Inc.), 380 F.3d 1292 (10th Cir. 2004)

- Equitable subordination and recharacterization case
- Adopts Fifth Circuit's *Mobile Steel* analysis for equitable subordination (citing to Tenth Circuit's prior decision in *Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.)*, 990 F.2d 551, 559 (10th Cir. 1993))
- Declines to extend "no fault" equitable subordination outside of the tax penalty area (*United States v. Reorganized CF&I Fabricators of Utah (In re CF&I Fabricators of Utah, Inc.)*, 53 F.3d 1155 (10th Cir. 1995)), and requires showing of inequitable conduct for equitable subordination; none shown
- Refers to *Autostyle Plastics* and adopts a 13-factor test similar to *Autostyle* and *Roth Steel*:

1. Names given to the certificates evidencing the indebtedness
2. Presence or absence of fixed maturity date
3. Source of payments
4. Right to enforce payment of principal and interest
5. Participation in management flowing as a result
6. Status of contribution in relation to regular corporate creditors
7. Intent of the parties
8. "Thin" or adequate capitalization
9. Identity of interest between creditor and stockholder
10. Source of interest payments
11. Ability of corporation to obtain loans from outside lending institutions
12. Extent to which advance was used to acquire capital assets
13. Failure of debtor to repay on the due date or to seek a postponement

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RECHARACTERIZATION CASES

Cohen v. KB Mezzanine Fund II, LP (In re Submicron Sys. Corp.), 432 F.3d 448 (3d Cir. 2004)

- Court declines to adopt any particular test, saying that it's the intent of the parties that really matters.
- "No mechanistic scorecard suffices. And none should, for kabuki outcomes elude difficult fact patterns . . . . [t]he determinative inquiry in classifying advances as debt or equity is the intent of the parties as it existed at the time of the transaction." Court declined to recharacterize or equitably subordinate.

Dornier GMBH v. The Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditor for Dornier Aviation (North America), Inc.), 453 F.3d 225 (4th Cir. 2006)

- Court declares that 4th Circuit agrees that recharacterization is "well within the broad powers afforded a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726" and "is integral to the consistent application of the bankruptcy code" thus "join[ing] every other circuit that has considered the question."
- Adopts the *Autostyle* 11-part test (from *Roth Steel)*
- Recharacterization affirmed based on insider status, lack of fixed maturity date, no requirement to repay until subsidiary became profitable, long history of sub's unprofitability and parent's assumption of sub's losses

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RECHARACTERIZATION CASES

Grossman v. Lothian Oil Incorporated (In re Lothian Oil Incorporated), 650 F.3d 539 (5th Cir. 2011)

- "We conclude that recharacterization extends beyond insiders and is part of the bankruptcy court's authority to allow and disallow claims under 11 U.S.C. § 502."
- Referring to the language of section 502 as well as the Supreme Court's decision in *Butner v. U.S.*, 440 U.S. 78 (1979) (holding that state law determines property rights in bankruptcy), Fifth Circuit holds that "[t]aken together, *Butner* and § 502(b) support the bankruptcy court's authority to recharacterize claims. If a claim asserts a debt that is contrary to state law, the bankruptcy court may not allow the claim. Moreover, where the reason for such disallowance is that state law classifies the interest as equity rather than debt, then implementing state law as envisioned in *Butner* requires different treatment than simply disallowing the claim."
- Distinguishes the basis for recharacterization relied on by the 3d, 4th 6th and 10th Circuits -- section 105(a) -- because reliance on section 105(a) is unnecessary.
- Looking at Texas law, Court affirms the disallowance of the claim and recharacterization as equity. Texas law imports a multi-factor federal tax law analysis.

Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.), 714 F.3d 1411 (9th Cir. 2013)

- Rejecting the long-standing holding of *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P 9th Cir. 1986), the Ninth Circuit joins sister circuits in concluding that the Bankruptcy Code gives courts the authority to recharacterize claims in bankruptcy.
- Recognizing the "framework split" that was recognized in *Lothian Oil*, and adopting the state-law-oriented approach consistent with the Supreme Court's *Butner* decision and *Lothian Oil*, and holding that "in order to determine whether a particular obligation owed by the debtor is a 'claim' for purposes of bankruptcy law, it is first necessary to determine whether that obligation gives the holder of the obligation a 'right to payment' under state law."

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ANOTHER POSSIBLE THEORY: DE FACTO PARTNERSHIP

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DE FACTO PARTNERSHIP

Lain v. ZC Specialty Ins. Co. (In re Senior Living Props., LLC), 309 B.R. 223 (Bankr. N.D. Tex. 2004)

Plan trustee sued ZC specialty insurance company ("ZC") for a declaration that ZC was a partner with SLP in the ownership and operation of SLP's nursing homes in Texas and Illinois and that, as a result, ZC was liable for all of SLP's debts. ZC countered that it merely held a debtor-creditor relationship with SLP, due to providing a surety bond for the payment of a large portion of SLP's mortgage owing to GMAC commercial mortgage corporation ("GMAC").

The focus of the parties, and the court's decision, was the contractual relationship between the parties and specifically, the terms of a certain reimbursement agreement and related agreements and documents between the parties. The court applied Illinois partnership law, as the reimbursement agreement contained an Illinois choice of law provision, and found that, under the Illinois uniform partnership act, among other things and with certain exceptions, when a person receives a share of the profits of a business it will be considered prima facie evidence that such person is a partner in the business.

Court found, *inter alia*, that under the terms of the reimbursement agreement, the fees being paid to ZC were from free cash flow (*i.e*, profits) instead of operating revenue, and was thus *prima facie* evidence that ZC was SLP's partner under Illinois law. General requirements are (i) community of interest in the venture, (ii) agreement to share profits, (iii) agreement to share losses, and (iv) mutual right of control or management of the business. *Id.* at 267-69.

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DO BAD ACTS TRAVEL WITH THE CLAIM?

(Or, put another way, can a transferee be equitably subordinated, or have its claim disallowed, simply because the claim itself may be subject to disallowance?)

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TRAVELLING BAD ACTS?

Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.), 379 B.R. 425 (S.D.N.Y. 2007).

The debtor filed an adversary proceeding against transferee of creditors claims, seeking equitable subordination of the claims based on the acts of the transferor, and disallowance of the claims under section 502(d) on the grounds that the transferor had received an avoidable transfer that had not been repaid.

Reversing the bankruptcy court, the district court held that equitable subordination and disallowance under 502(d) are ***disabilities that are personal in nature***, and do not inhere to or travel with the claim ***if it is sold***. In the context of an assignment, however (or another context wherein the transferee stands in the shoes of the transferor), the transferee takes the claim subject to any disabilities of the transferor.

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TRAVELLING BAD ACTS?

Conversely, however, in *In re KB Toys Inc.*, 736 F.3d 247 (3d Cir. 2013), the Third Circuit held that a disability under section 502(d) was not personal in nature, but ***inherent to the claim itself***.

In *KB Toys*, ASM Capital purchased nine (9) unsecured trade claims from creditors who were – post-sale – sued by the liquidating trustee for having received preferences. The trustee also sought to disallow the claims (now held by ASM) pursuant to section 502(d), which states that "the court shall disallow any claim of any entity from which property is recoverable under section . . . 550 . . . of this title or that is a transferee of a transfer avoidable under section . . . 547 . . . of this title, unless such entity or transferee" has re-paid the preference.

Holding that the infirmity is "claim-oriented" rather than "claimant-oriented," the court focused on the language of section 502(d), which "operates to render a ***category of claims*** disallowable", and which "focuses on claims and not claimants." *Id*. at 252-53.

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TRAVELLING BAD ACTS?

Policy concerns raised by the parties and addressed by the courts:

- Claims “washing”
- Equality of distribution of an estate’s assets
- Coercing compliance with court orders
- Conduct/sophistication of the purchaser (which indicates that the purchaser knew this could be a potential problem; and which allows a purchaser to protect itself, whereas the original holder doing business with the debtor prepetition could not)
- Time value of money in pursuing direct action against transferor for fraud
- Insolvency of the transferor